

EX PARTE OR LATE FILED



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Donald F. Evans  
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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

November 17, 1994

William F. Caton  
Acting Secretary  
Federal Communications Commission  
1919 M Street, N.W.  
Washington, D.C. 20554

DOCKET FILE COPY ORIGINAL

Re: EX-PARTE, CC Docket 94-1

Dear Mr. Caton:

In accordance with the Commission's Rules governing EX-PARTE communications, be advised that Doug Maine, MCI's Chief Financial Officer, and I met with Commissioner Chong and her staff today. We discussed MCI's position in the above captioned proceeding and provided a financial analysis of cash flow. The attached documents were used in our presentation.

Please place a copy of this notice and the attached documents in the record of the above captioned proceeding.

Sincerely,

  
Donald F. Evans

cc: Commissioner Chong  
Richard Welch

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List A B C D E



## PERFORMANCE REVIEW

- The Commission noted that the Performance Review would reconsider all aspects of the price cap plan

"The transition from rate of return to price cap regulation is a complex one, and, while we have made every effort to consider each relevant factor carefully and to base our determinations in reason and experience, some fine-tuning will probably prove necessary."

LEC Price Cap Order, para. 385

"The performance review should provide sufficient information to allow the Commission to reevaluate the need for lower end adjustment and sharing mechanisms, and to adjust the sharing mechanism and productivity factor if necessary. At that time, we will evaluate all aspects of the price cap plan and of LEC performance."

LEC Price Cap Order, para. 394

- Recalibration of the productivity factor or the sharing mechanism does not destroy price cap incentives

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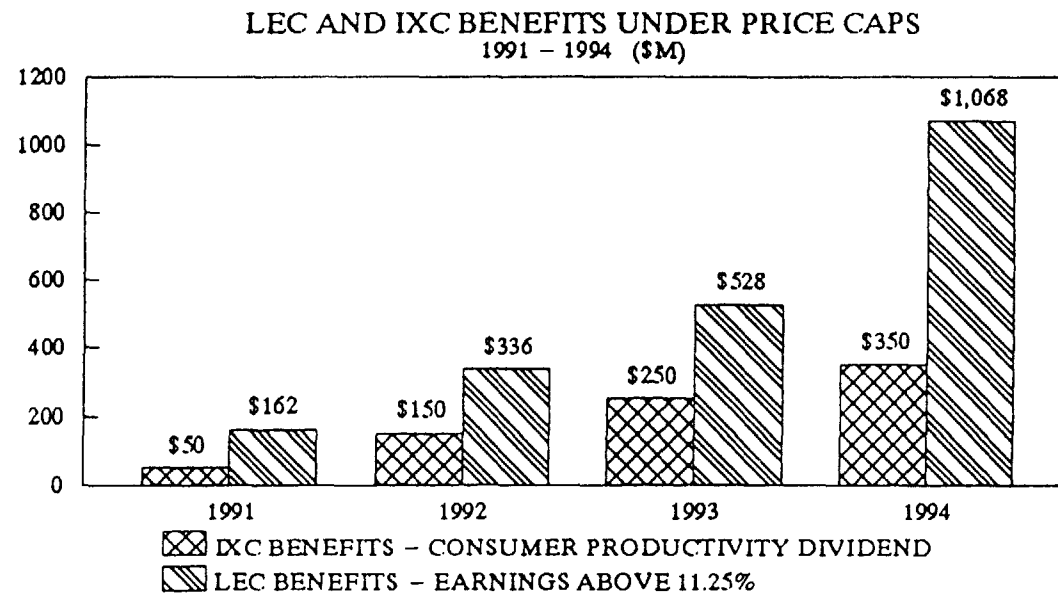
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## LEC WINDFALLS

- Half the growth in CCL minutes of use
- No recalibration of TS Switching rates when the trunking basket was created
- Cost of capital dropped early in the price cap period
- Many unplanned exogenous changes

## BENEFITS OF PRICE CAPS

- Benefits of price caps have been overly skewed toward the LECs
- The value to LECs of earnings above 11.25% has exceeded the benefit to the IXC's of the 0.5% Consumer Productivity Dividend



## NEEDED CHANGES TO THE PRICE CAP PLAN

- Increase the productivity factor
- Recalibrate rates to reflect lower cost of capital
- Limit future exogenous changes
- Retain sharing

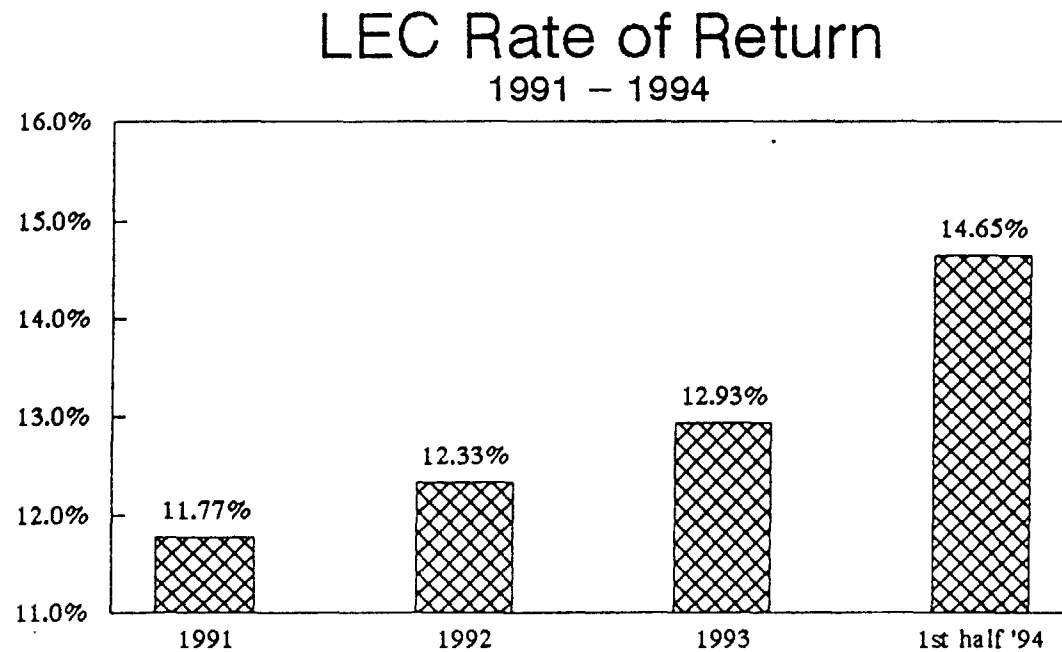
# PRODUCTIVITY

- Productivity factor should be increased
- Commission's original choice of productivity factor was a "conservative minimum figure"

LEC Price Cap Order, para. 99.

## PRODUCTIVITY (cont'd.)

- LEC earnings have consistently risen under price caps



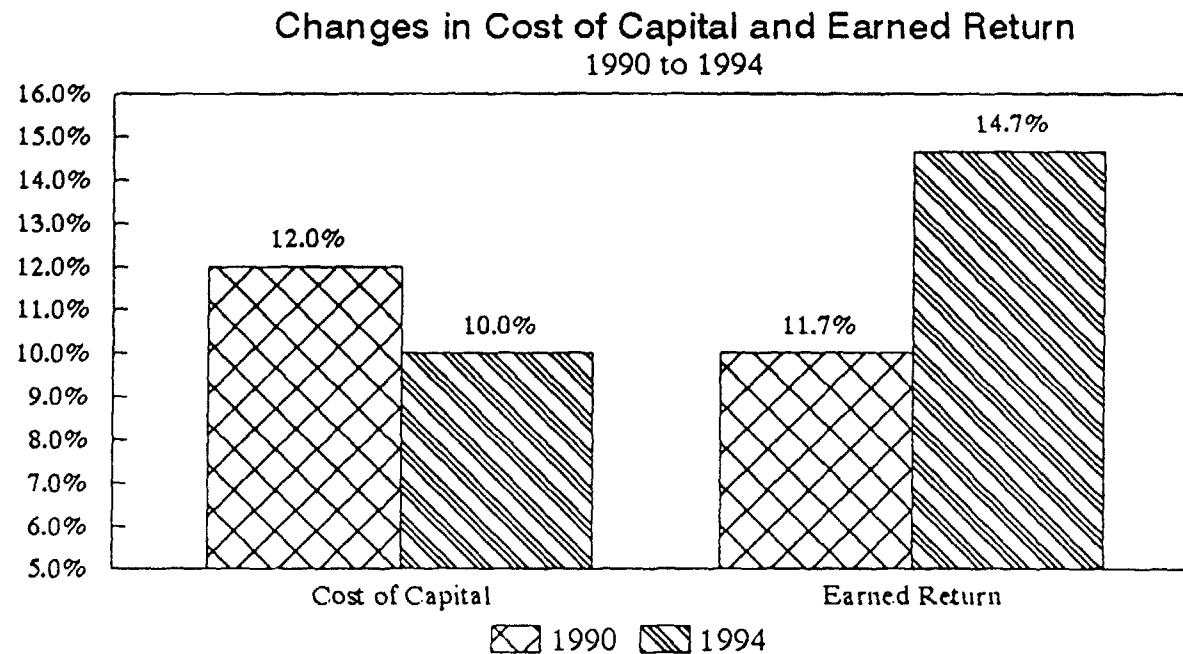
## PRODUCTIVITY (cont'd.)

- An X of 5.9% would be consistent with both the original short-term study and the LECs' performance under price caps



## RATE OF RETURN

- Cost of capital has declined since 1990, while earned returns have risen

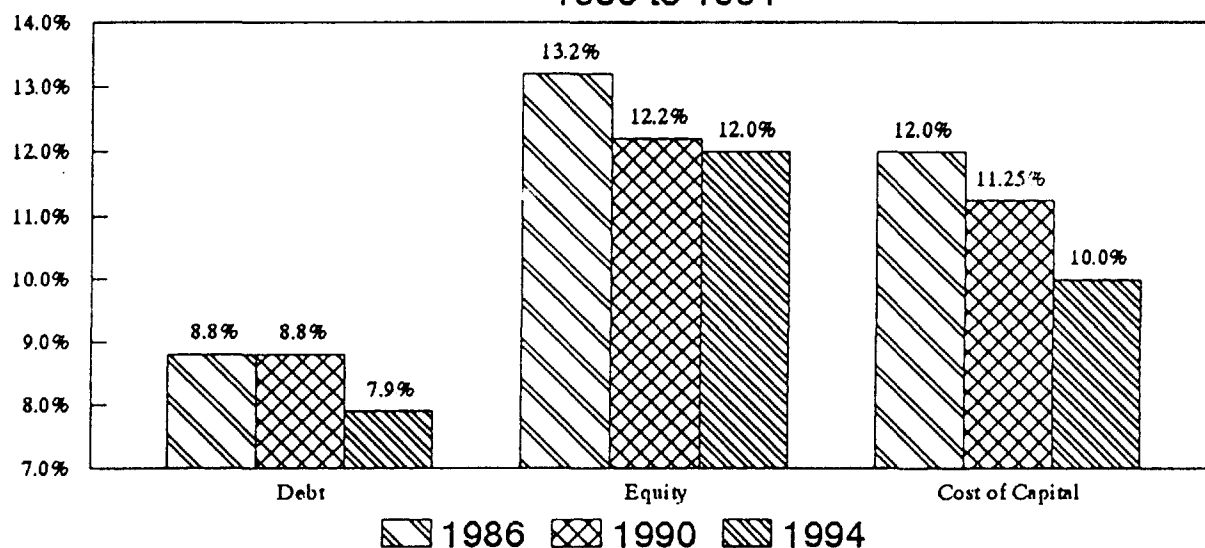


## RATE OF RETURN (cont'd.)

- Updating the Commission's 1990 methodology with data through July 1994, the current cost of capital is 10 percent

### LEC CAPITAL COSTS

1986 to 1994



## RATE OF RETURN (cont'd.)

- Rate of Return changes are not captured in GNPPI – X, because X was set based on studies which held the rate of return constant
- In a competitive industry, firms do not retain reduced costs of capital forever; eventually they must pass through those reduced costs into lower prices

## EXOGENOUS CHANGES

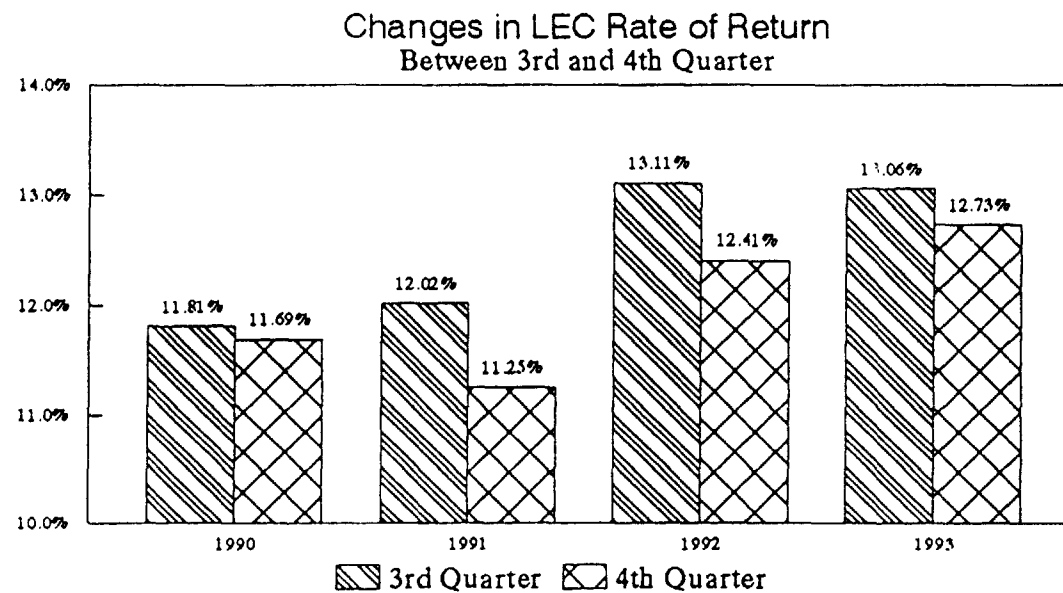
- Additional exogenous changes allowed by the Commission have increased rates by \$274.8 million
  - TRS \$10.6 Million
  - OPEB \$148.3 Million
  - GSF \$7.8 Million
  - 800 DB \$15.3 Million
  - TAXES \$37.4 Million

## SHARING

- Sharing should be maintained
  - Without sharing, the Commission lacks any meaningful enforcement mechanism
- The Lower Adjustment Mechanism is redundant
  - LECs can petition for above-cap filings
- Sharing levels should be reset to reflect the current cost of capital

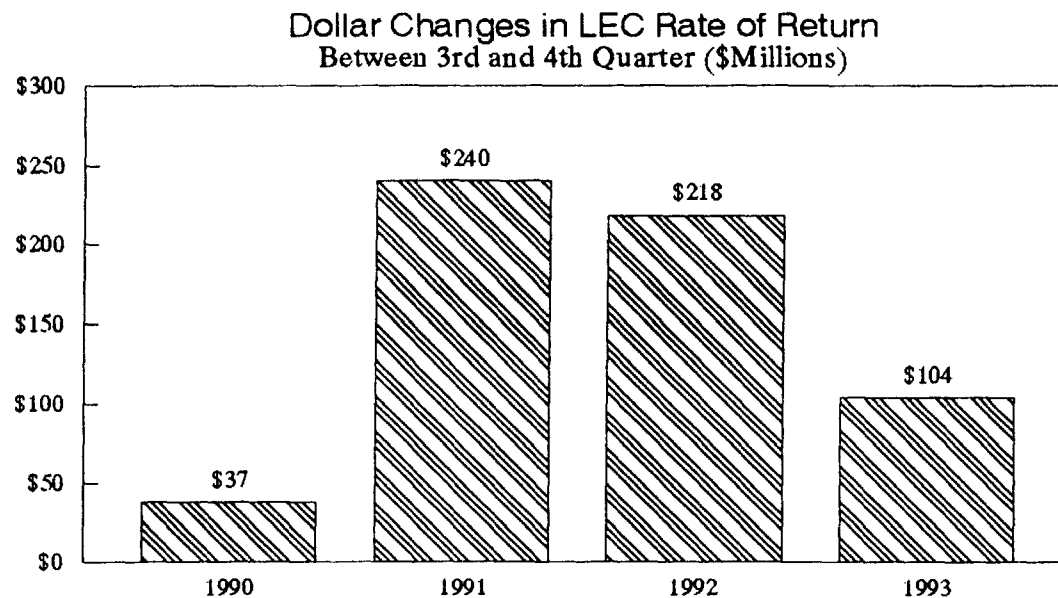
## SHARING (cont'd)

- LEC booking of large fourth quarter expenses should be curtailed



## SHARING (cont'd)

- LEC booking of large fourth quarter expenses has changed dramatically since price caps began



### Competitive IXC Market

	<u>1993</u>
Revenue	\$63.5B
Market Capitalization	95.0B
Operating Cashflow (EBITDA)	11.4B
EBITDA Margin	18%

### Non-Competitive LEC Market Price Cap LECs

	<u>1993</u>
Revenue	\$86.7B
Market Capitalization	187.0B
Operating Cashflow (EBITDA)	38.4B
EBITDA Margin	44%

	Revenue	EBITDA	EBITDA Margin	% of Total
Local	\$38.8B	\$6.7B	17%	17%
Access	24.9B	18.7B	75%	49%
Toll	11.8B	8.3B	70%	22%
Misc.	11.2B	4.7B	42%	12%

#### Notes:

- 1). Price Cap LECs include the seven RHCs and GTE.
- 2). Sources: FCC data, Company Annual Reports and 10ks, and industry analysts reports.



## **Access charges fund generous dividend payout and investments in new ventures.**

	<u>1993</u>
Total access charges paid to Price CAP LECs	\$24.9B
Operating Cash Flow (EBITDA) margin on access charges	<u>x 75%</u>
Operating Cash Flow on Access Charges	\$18.7B
Network reinvestment rate (amount invested in local plant)	<u>x 52%</u>
Amount available for dividends and for investment in new ventures	\$9.7B
Amount dividended out to shareholders (payout rate is 21% of EBITDA)	<u>- \$3.9B</u>
Amount remaining for new ventures and taxes	<u><u>\$5.8B</u></u>

During the period 1991 through 1993, \$15B was invested in new ventures. Only \$1.7B was capitalized through external funding.